

STATE OF CALIFORNIA

105.0069

BOARD OF EQUALIZATION

BUSINESS TAXES APPEALS REVIEW SECTION

In the Matter of the Petitions)	
for Redetermination Under the)	DECISION AND RECOMMENDATION
Sales and Use Tax Law of:)	
)	
C. R. S---)	Nos. SP UT XX-XXXXXXX-010
)	
K--- A---, INC.)	SP UT XX-XXXXXXX-010
)	
)	
<u>Petitioner</u>)	

The Appeals conference in the related above-referenced matters were held by Staff Counsel Lucian Khan on June 24, 1993 in Fresno, California.

Appearing for Petitioner:

N--- R. G---
Certified Public Accountant

Appearing for the
Sales and Use Tax Department
(SUTD):

Charles Tavookjian
Supervising Tax Auditor

Roger Parvanian
Tax Auditor

Protested Item

Each petition protests tax liability assessed for the purchase of aircraft for use in California in the amount of \$2,550,000.

Contentions

C. R. S--- - The aircraft is exempt under Revenue and Taxation Code Section 6366.1 since it was leased to a common carrier.

K--- A---, Inc. - In addition to being exempt under Revenue and Taxation Code Section 6366.1, the transaction is exempt under Regulation 1595(b)(2) as a transfer of substantially all property without a substantial change in ownership, and exempt under Regulation 1595(b)(4) as a contribution to a commencing corporation.

C. R. S---
SP UT XX-XXXXXX-010
K--- A---, INC.
SP UT XX-XXXXXX-010

-2-

January 7, 1994

105.0069

Summary

The petitions involve two related transactions. In the first transaction, Mr. C. R. S--- purchased the aircraft outside California, then flew it into California. In the second transaction, Mr. S--- transferred the same aircraft to K--- A---, Inc. in exchange for shares of stock and assumption of the loan balance. Each petition alleges there was a lease of the aircraft to a common carrier - SH---, Inc. The relevant facts and events surrounding these transactions are as follows.

On April 29, 1987, Mr. S--- ordered the subject aircraft from U--- B---, Inc. The aircraft was a 1987 --- model 300, ser. no. FA-XXX, reg. no. NXXXXXX (now NXXXS). The purchase order lists Mr. S--- as the purchaser, and a purchase price of \$2,550,000.

On May 14, 1987, the aircraft was delivered to Mr. S--- in ---, Kansas. On that same day, Mr. S--- signed a promissory note in the amount of \$2,000,000. The aircraft entered California on or about May 23, 1987; however, SUTD finds the date of first operational use was May 16, 1987.

Sometime prior to August 3, 1987, Mr. S--- transferred the aircraft to K--- A---, Inc. To complete the transfer, K--- A--- assumed a \$2,000,000 loan balance on the aircraft and issued 55,000 shares of K--- A--- stock to Mr. S---. The value of the stock was \$10 per share.

On August 3, 1987, K--- A---, Inc. (lessor) and SH---, Inc. (lessee) entered into a lease of the aircraft. The effective date is July 1, 1987, and for a term of two years. According to the lease, SH--- is required to lease the aircraft at the rate of \$750 per hour, and pay one-half that amount to K--- A---. C. R. S--- signed the lease as president of K--- A---, Inc., and C--- J. R--- signed as president of SH---, Inc. Articles of Incorporation for K--- A---, Inc. show the effective date of incorporation as July 29, 1987. There was never any written lease agreement between Mr. S--- and SH---.

A copy of SH---'s "Air Carrier Operating Certificate" was submitted. This certificate was issued by the Federal Aviation Administration (FAA) with a reissue date of July 24, 1979. The certificate number is 4WE-27.

In a May 16, 1988 letter from the FAA to SH---, SH--- was authorized to conduct general and air carrier operations. The authorized aircraft listed is the same aircraft which is the subject of both petitions. Petitioner claims verbal permission was obtained by the FAA on January 29, 1988.

Flight logs and invoices concerning the use of the aircraft were submitted, and income tax returns for K--- A--- (1987, 1988, 1989) and Mr. S--- (1987, 1988).

On July 14, 1992, an earlier conference was held in Sacramento by Staff Counsel Cynthia Spencer-Ayres. Mr. G--- was present at the conference, and requested additional time to submit more documentation.

On July 23, 1992, Paul Erikson of the Petitions Unit sent a letter to Mr. G--- detailing the documentation needed. Among the information requested was the following: (1) aircraft flight logs for the period July 10, 1988 through July 30, 1988 (logs up to July 9, 1988 were previously provided). (2) copies of SH---'s revenue and customers billing. (3) Engine and aircraft maintenance logs, and copies of all repair and maintenance receipts. (4) Trip logs. (5) A copy of SH---'s Part 135 manual showing the date the aircraft was added to its air carrier fleet, and showing the names of the certified air pilots and the list of rules for operation of the aircraft. (6) Evidence of lease payments made for the use of the aircraft, such as copies of cancelled checks.

On September 15, 1992, Mr. G--- called Cynthia Spencer-Ayres, stating the documents were ready to send; however, on October 14, 1992, Mr. G--- again called, and requested additional time.

On June 24, 1993, a second conference was necessary because Ms. Spencer-Ayres had left the Board of Equalization prior to preparing a Decision and Recommendation. She was awaiting the documentation from Mr. G---, but it never arrived.

At the second conference, Mr. G--- appeared with copies of various documents, but none of the information requested in Paul Erikson's letter of July 23, 1992. It was pointed out to Mr. G--- the information must be submitted for the exemption(s) to be considered. Mr. G--- was given a deadline of July 23, 1993 to submit the documentation. In a letter dated July 23, 1993, Mr. G--- requested an extension until August 31, 1993. The extension was requested because of previous commitments regarding unrelated matters and an upcoming surgery for Mr. G---.

Petitioner (Mr. S---) argues the initial purchase of the aircraft is exempt from use tax under Revenue and Taxation Code Section 6366.1 because he leased the aircraft to SH--- for its use as a common carrier. He admits there was no written lease agreement.

Petitioner argues the transfer to K--- A--- is also exempt based on the lease between K--- A--- and SH---. In addition, the transfer is exempt under Regulation 1595(b)(2) as a transfer of substantially all property without a substantial change in ownership, and exempt under subsection (b)(4) as a contribution to a commencing corporation solely for first issue of stock.

SUTD argues the purchase by Mr. S--- is not exempt from the use tax because he has not submitted the required documentation to obtain the exemption under Section 6366.1. An invoice from SH--- covering the period May 29, 1987 to July 22, 1987 shows 46.9 hours of flight time was billed at the rate of \$750 per hour; however, when comparing the flight log for the same corresponding time period, there were additional unexplained flights which amounted to 38.2 hours. Of the 46.9 hours which were explained, the majority of this usage was by petitioner, and principals of SH--- or their related entities. The aircraft was not held out indiscriminately to the public for hire; therefore, the requirements of Section 6366.1 have not been met. A listing of petitioner's related entities was submitted, and is attached as Exhibit 1.

As to the transfer of the aircraft to K--- A---, SUTD also argues the requirements of Section 6366.1 have not been met. Invoices from SH--- for the time period of July 30, 1987 through June 7, 1988 account for a total of 297.9 hours; however, a review of the flight log for the same corresponding period shows 31.6 hours are not properly accounted for. Of the 297.9 hours invoiced, most of the hours relate to usage by petitioner, principals of SH--- and related entities. The documentation requested at the first conference in June 1992 has not yet been submitted.

SUTD further argues the transfer to K--- A--- is not exempt under Regulation 1595(b)(2) because there is no evidence the aircraft was included in a transfer of all or substantially all the property held in the course of business activities. The transfer also is not exempt under subdivision (b)(4) because there was an assumption of the loan for the aircraft.

On August 31, 1993, Mr. G--- sent a cover letter and large packet of documents which was forwarded to the Petitions Section for review, and comments. In a memorandum dated October 19, 1993, SUTD argues the new evidence does not prove that Mr. S--- leased or used the aircraft in common carrier operations; however, he did make a taxable use of it. The aircraft was effectively transferred to K--- A--- on July 29, 1987, and first operationally used the following day. Therefore, the 12 consecutive month test period commenced July 30, 1987 and ended on July 29, 1988; however, the FAA did not authorize use of the aircraft as a common carrier until May 16, 1988. The trip logs show the aircraft was used 260.9 hours prior to FAA authorization. At the time Mr. S--- transferred the aircraft to K--- A---, it had flown 95.8 hours. The 260.9 hours represent 75 percent of the combined total time the aircraft was used in non-common carrier operations prior to FAA authorization. Therefore, the exemption should be denied. If petitioner is able to prove the FAA authorized use of the aircraft at an earlier date, then the exemption may be determined on whether the use of the aircraft by Mr. S--- or his closely related entities would constitute common carrier usage. Approximately 17.5 hours, or five percent use, was made by members of the public, while the remaining 95 percent was

related to use by Mr. S--- or his related entities. Therefore, the use of the aircraft was not offered indiscriminately to the public.

The information submitted with petitioner's August 31, 1993 letter consists of the following: (1) copies of various invoices from SH---, Inc., covering the period of May 29, 1987 through July 25, 1988; (2) trip logs from SH---, Inc., covering the period of May 25, 1987 through June 20, 1988; (3) a summary of flight time provided by SH---, Inc., covering the period October 26, 1987 through January 31, 1989; (4) repair invoices for the subject aircraft covering the period of June 9, 1987 through December 1, 1988; (5) a copy of an insurance policy endorsement dated May 21, 1987 showing the subject aircraft was insured by SH---, Inc., on May 5, 1987; (6) computer-generated copies of a document entitled "Detail Customer Leaseback Report" for the months of August, September, October, November, and December of 1988. The reports apparently relate to income received by K--- A--- for lease of the subject aircraft; (7) a document from the FAA entitled "Operations Specifications". The document lists certain types of aircraft which are authorized as of January 11, 1988 for purposes of conducting operations under the provisions of Part 135 for the use of aircraft. The particular aircraft in question is not mentioned in this document; however, the particular type of make or model is listed. The name "SH---, Inc." is listed at the bottom of the form, and the certificate number is CUIA931D; (8) photocopies of cancelled checks made payable to C. R. S--- and K--- A---, Inc., from SH---, Inc. These payments apparently represent amounts owed by SH--- for the lease of the aircraft.

Because of a different certificate number on the "Air Carrier Operating Certificate" (4WE-27) and the "Operations Specifications" form (CUIA031D), the FAA was contacted to determine if SH--- held either or both of the certificates. FAA records show both were held by SH---; however, the current certificate number is CUIA031D.

Analysis and Conclusions

Purchase by C. R. S---

Revenue and Taxation Code Section 6366.1 provides that neither the sales tax nor the use tax will apply to the purchase or lease of an airplane by a person who will use the aircraft himself in common carrier operations or lease it to another who will so use the aircraft. To interpret and apply this section, the Board has adopted Sales and Use Tax Regulation 1593. Subdivision (a) defines the term "common carrier" to mean "any person who engages in the business of transporting persons or property for hire or compensation and who offers his services indiscriminately to the public or to some portion of the public."

To determine whether the airplane is used as a common carrier, subdivision (b) provides for a test period of 12 consecutive months beginning with the aircraft's first operational use.

"Operational use" means the actual time during which the aircraft is operated. However, it does not include test flights, repair, or personnel training. If the aircraft is used as a common carrier for more than one-half of its operational use during this 12-month period, the purchase or lease of the airplane qualifies as an exempt purchase. If the purchaser does not own the aircraft for 12 consecutive months, then only the period of time commencing with the first operational use that the purchaser owns the aircraft will be considered.

Subdivision (b) also provides that there is a rebuttable presumption that the aircraft was not regularly used as a common carrier if the yearly gross receipts from the use of the aircraft, or the yearly lease receipts from the lessor's lease of the aircraft, do not exceed 10 percent of the cost of the aircraft, or \$25,000, whichever is less.

Regulations pertaining to common carrier operations are set forth in Part 135, subchapter (G), of Title 14 of the Code of Federal Regulations (CFR). A Part 135 operator must comply with all the rules of Part 135 (14 CFR 135.3(a)). The carrier is required to prepare and maintain a manual and other records containing operational specifications/procedures, a list of each aircraft used for such operations, and a list of each pilot used in such operations (14 CFR 135.21, .23, and .63(a)). Each carrier can only operate a particular type of aircraft if it obtains authority for the specific category and class of aircraft (14 CFR 135.11(b) and .23(c), and .143(a)).

For petitioner to obtain the exemption allowed under Section 6366.1, and Regulation 1593, there must also be compliance with all the rules of Part 135 of Title 14 of the Code of Federal Regulations. Part 135 requires that both the operator (SH---) and the aircraft be certified before commencing operations as a common carrier.

The evidence shows SH--- obtained operating authority from the FAA on July 24, 1979; however, a new certificate number was issued sometime later, and is reflected on the "Operations Specifications" form. Authority for the operation of the aircraft, however, was not granted by the FAA until its May 16, 1988 letter. Although the "Operations Specifications" form shows an earlier date of January 11, 1988, this form only provides that petitioner may fly an aircraft of the same make and model (Beech 300), but does not specifically identify the subject aircraft as being authorized for operation.

The transfer of the aircraft to K--- A--- could not have occurred any earlier than its incorporation date (July 29, 1987); therefore, the July 1, 1987 effective date of the lease between K--- A--- and SH--- was premature. The test period to qualify for the exemption started on the May 16, 1987 date of first operational use until the July 29, 1987 transfer to K--- A---. Since the plane was not certified by the FAA until after this period (May 16, 1988), none of the hours of operation can be credited toward the exemption.

If, in a Request for Reconsideration, it can be shown the plane was certified during this entire period, Mr. S--- would be entitled to the exemption, providing more than one-half of the operational use during the test period was for common carrier purposes. According to the flight logs (pp. A-50, 51 petition file), the Hobbs recorded 85.1 hours (95.8-10.7) of operational use for the period of May 16, 1987 to July 29, 1987. For this period, SH--- issued invoices for a total of 48.3 hours. Of this total, SH--- billed 41 hours to Mr. S---, 2.4 hours to S. K. R---, 3.5 hours to C. J. R---, and 1.4 hours to C--- F---. The remaining 36.8 hours is generally unexplained because the trip logs for the subject aircraft start on May 29, 1987 (May 25, 1987 for another aircraft) and show a Tach reading of 37.4 hours. Flight time from May 16, 1987 through May 28, 1987, which consists of 26.7 hours (37.4-10.7) is only accounted for in the flight logs (not trip logs) which provides no explanation of the reason for the flights. The trip logs for the period of May 29, 1987 through July 29, 1987 also show another .8 hours which is unexplained. Adding together the above figures (48.3, 26.7 and .8) provides for a total of 75.8 hours, with the remaining time (9.3 hours) related to engine repair or pilot training. Since the 9.3 hours relating to engine repair and training are not included within the hours of operational use, petitioner need only show that more than one-half of the 75.8 hours were used for common carriage purposes. Although the entire 48.3 hours for which SH--- billed was related to use by Mr. S--- or his related entities (see Exhibit 1 attached), it does not necessarily mean that SH--- did not offer its services indiscriminately to the public, or some portion. We have consistently regarded charter of an aircraft to an owner of the aircraft as common carriage only if the owner is required to charter the aircraft on the same basis as any other customer. Here, all invoices show that SH--- billed at the rate of \$775 per hour whether the plane was chartered by Mr. S---, his related entities, or unrelated third parties. Therefore, the 48.3 hours billed to Mr. S--- and his related entities would exceed the required 50 percent threshold of the total 75.8 hours of operational use. I find no authority in support of SUTD's argument that simply because Mr. S--- or his related entities chartered the aircraft that those hours would not count towards common carriage purposes. However, since petitioner cannot prove an earlier certification date for the aircraft, the burden to obtain this exemption has not been met.

Transfer to K--- A---

Since the transfer of the aircraft from Mr. S--- to K--- A--- occurred effectively July 29, 1987, the 12-month test period under Regulation 1593(b) commenced on July 30, 1987 through July 29, 1988. All hours during this test period prior to certification of the aircraft by FAA (May 16, 1988) would not count towards the exemption. Therefore, the only hours which may be counted towards the exemption are those used for common carriage between the period of May 16, 1988 and July 29, 1988. If the number of common carriage hours during this time period is greater than the remaining hours of operational use for the entire 12-month period, K--- A--- would be entitled to the exemption provided all documentation has been submitted and verified.

Prior to July 30, 1987, the aircraft had flown 95.8 hours. From that date until the May 16, 1988 FAA certification, the aircraft flew an additional 260.9 hours (356.7-95.8). Between the May 16, 1988 FAA certification date and the end of the 12-month test period (July 29, 1988), the aircraft flew an additional 87.1 hours, for a 12-month total of 348 hours. (July 30, 1987-July 29, 1988.) Of the 348 hours of flight time during the 12-month test period, only 81.8 hours were billed by SH--- as flight time from the May 16, 1988 FAA certification date through July 29, 1988. Because petitioner was required to operate the aircraft for common carriage purposes more than one-half of the 348 hours flown, the requirements for this exemption have not been met. If, however, petitioner can prove an earlier certification date, it may be entitled to this exemption.

The transfer to K--- A--- is not exempt under Regulation 1595(b)(2). To qualify for this exemption, not only must there be a transfer of substantially all property without a substantial change in ownership, the property must also be held or used by a person in the course of activities which require the holding of a seller's permit.

Annotation 395.1360 specifies three elements which must be present: (1) the transfer must be of all or substantially all the property; (2) the property must be held or used in the course of an activity for which a seller's permit is required; and (3) after the transfer, the real or ultimate ownership of the property involved must be substantially similar (80 percent rule) to that which existed before the transfer.

Here, the ultimate ownership of the aircraft was substantially similar after the transfer because Mr. S--- owned 100 percent of the K--- A--- stock. There has been no proof, however, that Mr. S--- either held or was required to hold a seller's permit for his activity relating to the use of the aircraft. Petitioner bears the burden of proof to obtain the exemption.

The transfer of the aircraft is also not exempt under subdivision (b)(4) as a contribution of property to a commencing corporation. To qualify for this exemption, there must be a transfer of the property to a commencing corporation solely in exchange for first issue of stock. At the time of the transfer, Mr. S--- received the first issue of 55,000 shares of stock, and K--- A--- also assumed a loan balance on the aircraft in the amount of \$2,000,000. Because of the assumption, the transfer does not qualify for the exemption. I do note, however, the measure of tax as stated in the determination is \$2,550,000, and therefore includes both the loan balance assumed and stated value of K--- A--- stock. The value of the stock received by Mr. S--- does not amount to taxable consideration; therefore, the measure must be reduced by \$550,000 (Annotation 395.1820).

C. R. S---
SP UT XX-XXXXXX-010
K--- A---, INC.
SP UT XX-XXXXXX-010

-9-

January 7, 1994

105.0069

Recommendation

For C. R. S--- - redetermine without adjustment.

For K--- A--- - reduce the measure by \$550,000; otherwise, redetermine without adjustment.

Lucian Khan, Staff Counsel

1/7/94

Date

Attachment: Exhibit 1